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International Economic & Energy Weekly

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20 September 1985

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International
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20 September 1985

Comments and queries regarding this publication are welcome. They may be directed to [redacted] *Directorate of Intelligence,* [redacted]

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3 **Latin America: Status of IMF-Supported Adjustment Programs** [redacted] 25X1

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9 **Plunging Commodity Prices Increasing LDC Financial Strains** [redacted] 25X1

The dramatic five-year fall in prices of nonoil commodities and resulting export earnings losses have been particularly stressful for key LDC debtors. 25X1 For 1986, a modest recovery in nonoil prices will be more than offset by continued declines in oil prices and the LDCs will suffer another, although less severe, drop in revenues. [redacted] 25X6

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Libya's expulsion of thousands of foreign nationals since early August threatens to destabilize Tunisia and is causing less severe problems for Egypt and several other regional states. [redacted]

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Moscow continues to reap major political and strategic benefits in return for its hefty economic assistance to Communist LDCs. Although Soviet economic assistance has remained at roughly the same level over the past four years, Moscow is pressing these countries to live up to commitments to provide the USSR with goods and raw materials. 25X1

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Perspective

IMF/World Bank Meeting: International Monetary Reform

Renewed debtor dissatisfaction with current international monetary arrangements has bolstered Third World resolve to urge reform during the annual IMF meeting next month in Seoul. Developing countries argue that sluggish world growth and their heavy debt burden—aggravated by high real interest rates, falling export prices, and net capital outflows—threaten established monetary relations with industrial countries. For the first time, LDCs have submitted proposed modifications for formal consideration by the IMF Interim Committee. The industrial countries will be pressured to address these LDC criticisms of the international monetary system:

- *Volatile exchange rates have discouraged world trade and investment in developing countries needed to service foreign debt.* Although developing countries favor eventually establishing target zones for exchange rates, they intend in the meantime to press major industrial countries to coordinate macroeconomic policies by submitting to an explicit consultation process with the IMF.

- *Increased economic interdependence has placed the burden of international adjustment on developing countries.* The Third World believes that the Fund should tighten surveillance over the monetary and fiscal policies of industrial countries and promote economic growth as an integral part of LDC adjustment, partly by easing the adjustment measures attached to international lending.

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- *International liquidity is insufficient.* Developing countries favor augmenting the loan base of the IMF and the World Bank, and they plan to demand increased access to cheaper credit from multilateral institutions.

Although the industrial countries share LDC concerns about key features of the monetary system—especially exchange rate volatility—most have agreed to block major institutional reform. Instead, they hope to reduce exchange rate fluctuations by improving the effectiveness of existing, informal coordination of macroeconomic policies—a strategy they jointly approved this summer. Consistent and sound macroeconomic policies in industrial countries would foster greater private lending—argue the United States, West Germany, and the United Kingdom—easing pressures to increase international liquidity with official funds.

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Although most industrial countries intend to listen sympathetically to the Third World proposals, we expect the LDCs to achieve little in Seoul. Developing countries may try to exploit differences of opinion existing among individual industrial countries to encourage movement toward monetary reform. France and Italy, in particular, provide a friendly ear to LDC lobbying for target zones and formal macroeconomic consultation with the IMF. Nevertheless, we believe the industrial countries will postpone indepth discussion of monetary reform, probably until the Fund's meeting next spring. [redacted] 25X1

The LDC proposals—if adopted—could complicate policymaking and put increased financial burden on the United States. Relations with allies could be strained as US policymakers face greater accountability to other industrial and developing countries under formal IMF consultations to coordinate macroeconomic policy. Increasing international liquidity through official channels would require greater US financial contributions to the IMF and the IBRD. LDC resistance to conditionality also could further reduce commercial bank lending to debtors, prompting calls from developing countries to make up the difference with US official assistance. [redacted] 25X1

[redacted] 25X1

Latin America: Status of IMF-Supported Adjustment Programs

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Peruvian President Garcia's outright refusal to negotiate with the Fund and Brazil's resistance to accept what it views as too rigid IMF conditions may portend a growing tendency in the region to challenge Fund prescriptions. The risk of a formal regionwide break with the Fund is not high. Although some of the region's debtors have made recent progress in reviving their IMF programs, we believe some Latin American leaders will continue to try to persuade the IMF to ease up on performance criteria. Failure to reconcile differences would undermine the IMF's central role in resolving the debt problems of the region and may oblige creditors to review their approach to the debt issue.

Staying With IMF Programs

Argentina and the IMF reached agreement on a new set of targets in June, after three months of difficult negotiations. The agreement called for a lowering of inflation to 8 percent per month by the first quarter of 1986 and for a drastic reduction in the budget deficit. The Alfonsin government has moved with unaccustomed swiftness in devaluing the currency 15.2 percent, raising public service and energy prices, freezing wages and prices, and promising to discontinue printing money to finance budget deficits. Despite the flexibility built into the new inflation and nominal monetary targets, we believe the difficulties of increasing budget revenues and decreasing spending may require the government to seek performance waivers from the IMF later this year.

In *Uruguay,* the Sanguinetti government also has revived its agreement with the Fund. According to press reports, IMF Managing Director de Larosiere has given tentative approval to an 18-month, $120 million standby arrangement in which Montevideo pledged to bring its fiscal deficit as a share of GDP down from 10 to 6 percent, to lower inflation to 60 percent from the current 78 percent, and to maintain a floating exchange rate. The prospective IMF package is enabling Uruguay to negotiate with its foreign commercial banks—which have agreed to roll over principal repayments until the end of September—for $130 million in new money and a debt rescheduling. 25X1

Several other Latin American debtors have reached agreements with the IMF in the last several months: 25X1

- After a six-month stalemate, *Chile*'s debt package was helped along when the IMF agreed in principle on 15 July to a new three-year program providing $850 million in assistance. This agreement, whose first disbursement of $140 million is likely this month, cleared the way for a 17 July Paris Club rescheduling of $170 million and spurred progress on the commercial bank package—currently over 90 percent complete.

- *Panama* received an $88 million, 21-month IMF standby arrangement, and its $877 million commercial bank refinancing package is nearly complete.

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Straying From The Fold

Rising foreign payments problems and large budget overruns have pushed *Mexico* out of compliance with IMF targets. Mexico's oil price cuts and export declines will reduce 1985 petroleum export earnings by about $1.5 billion from last year's level. Moreover, the $2 billion capital flight during the first half of 1985 was double the amount for all of last year. At the same time, the overvaluation of the peso has cut nonoil exports by more than 16 percent and contributed to the surge in imports, which rose some 39 percent in the first quarter of

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Status of IMF Programs and Compliance: Mexico, Argentina, and Chile

	Most Recent Target	Performance
Mexico [a]		
	Billion Mexican Pesos	
Net credits to the public sector by the Bank of Mexico [b]	4,902	Mexico is likely to violate target to finance the budget deficit.
Cumulative overall public-sector deficit	1,785	Mexico will substantially overshoot this target despite recent belt-tightening.
Cumulative changes in net domestic assets of the Bank of Mexico	184	Mexico is likely to miss the target despite changes in banking laws.
Cumulative change in net international reserves of the Bank of Mexico	500	Falling oil prices, higher imports, flat nonoil exports, and capital flight will cause Mexico to substantially undershoot target.
Argentina		
	Billion US $ (except where noted)	
Cash deficit of the nonfinancial public sector (*percent of GDP*) [c]	6.0	Several politically complicated steps need to be taken; expect some slippage.
Net domestic assets of Central Bank (*billion australs*) [d]	800	Difficult to judge.
Net international reserves [e]	−9.9	Attainable.
Limit on outstanding external payments arrears [e]	1.1	Attainable.
Consumer inflation (*percent change*) [f]	150	Within reach; some concern about reactions once price freeze is lifted.
Current account deficit [c]	2.0	Within reach; exports not doing well, but interest payments are lower due to fall in interest rates.

	Most Recent Target	Performance
Chile [g]		
	Billion US $ (except where noted)	
Current account deficit	1.38	Chile likely to miss target as exports remain depressed.
Gross international reserves	2.00	Chile has already drawn down over $700 million through August, according to US Embassy.
Public-sector deficit (*percent of GDP*)	3.5	Chile's deficit could hit 4 percent, violating target as government increases assistance for earthquake reconstruction.
Inflation (*percent change, Dec/Dec*)	25.0	Inflation is likely to run 30 to 35 percent.

[a] Targets set for fourth quarter 1985.
[b] Adjusted.
[c] Targets set for 1985.
[d] September 1985.
[e] December 1985.
[f] First quarter 1986 at annual rate.
[g] Targets set for calendar year 1985.

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this year compared with the same period in 1984. Finally, the government's politically motivated pre-election stimulation of the economy has caused a larger-than-expected budget deficit, the reduction of which was a key IMF target. [redacted]

President de la Madrid so far has been unwilling to take the necessary measures to put Mexico back into compliance with performance targets. Recent government projections indicate that economic austerity measures announced in late July and early August will not significantly trim the budget deficit for the year below some 8 to 9 percent of GDP. The same study also indicates that inflation for 1985 would be about 60 percent. Both figures are far in excess of IMF criteria and therefore jeopardize Mexico's final two drawings from the Fund. [redacted]

Brazil announced measures in early July to reduce the projected $18 billion public-sector deficit for this year, but the cuts were substantially smaller than those sought by the IMF. Negotiations with the Fund reached an impasse in August, and [redacted] President Sarney was reluctant to make additional budget cuts because of intense domestic political pressure to continue recovery. Instead, Sarney's chief economic adviser announced publicly on 13 August that Brazil would seek a "shadow agreement" under which the IMF would evaluate the results of Brasilia's program at the end of the year. [redacted]

Recent changes in Brazil's economic team will make a reconciliation with the IMF and negotiations with creditors even more difficult, in our view. In late August, Sarney replaced Finance Minister Dornelles with Dilson Funaro, who has consistently opposed tough austerity measures and criticized IMF policies. We believe that Brasilia probably will not conclude a new agreement until after the mid-November municipal elections in order to prevent the opposition from exploiting this sensitive issue. Although the impasse with the IMF is causing concern among bankers, [redacted] the immediate financial repercussions will likely be mild. According to the US Embassy, Brazil secured a 140-day rollover of maturing debt payments and short-term credits. With the present favorable trade surplus and adequate foreign exchange reserves, Brazil should be able to avoid problems in servicing its debt over the near term. [redacted]

Peru's President Garcia, inaugurated on 28 July, apparently remains committed to his pledge that he will not submit to a Fund accord and will limit foreign debt repayments to 10 percent of export earnings over the next 12 months. Peruvian officials have also requested a rollover of long-term debts maturing between July 1985 and 31 January 1986, according to the US Embassy. Garcia's public statements are impeding the resumption of debt negotiations, as many US and West European banks reportedly insist that no debt rescheduling talks can occur until Peru accepts an IMF-supported economic stabilization program. [redacted]

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A Murky Outlook

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Despite some recent rumblings among Latin debtors about radical action, we believe most regional leaders recognize that IMF-supported stabilization programs are essential to retain the cooperation of creditors. As they balance economic imperatives against political realities, however, they probably will take increasingly tougher stands on IMF recommendations. The Latin debtors probably will use the October IMF/World Bank meetings to press for additional concessions from the Fund. [redacted]

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Nonetheless, Garcia's refusal to negotiate with the Fund because of the potential social consequences reflects the increasing politicization of the debt issue. On the one hand, his tougher line with the IMF could generate domestic acquiescence to additional belt-tightening measures. This could eventually set the stage for a self-imposed stabilization program—monitored by the IMF—that would break the current financial impasse with creditors. His anti-IMF stance, however—and rhetoric backing unified debtor action—has caused bankers to

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Tougher Action on Debt?

Although we still believe a Latin American debtors cartel is not in the cards over the near term, the risk remains that these countries could begin opting for radical action. In recent weeks, we have detected some disturbing indications that a tougher political approach may be in the offing:

- *Based on US Embassy reports, we believe Peru's President Garcia will not hesitate to use public forums such as the UN General Assembly and Nonaligned Movement to push for better repayment terms, increased aid flows, and a political dialogue with creditors on the debt issues.* 25X1

- *President Lusinchi of Venezuela is under strong pressure from the political opposition and labor groups to scuttle the multiyear agreement negotiated with the bank advisory committee. Domestic critics argue that declining oil revenues necessitate a reopening of negotiations. We believe, however, Lusinchi is determined to go ahead with the scheduled September signing of the agreement and worry about any need to renegotiate later.*

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cease financial support; this could quickly create serious economic and political problems for the new government

Brazil may represent still another subtle test to the Fund's central role in regional debt adjustment. After the November elections, Sarney probably will relent in his opposition to tight austerity measures to clear the way for a new Fund agreement in 1986. There is a small possibility, however, that Sarney may propose a shadow role for the IMF and press commercial lenders for financial assistance without a formal program. Brasilia could seek something resembling Venezuela's arrangement, in which the Fund blesses a homegrown stabilization program and monitors progress through semiannual consultations. Such an approach dampens nationalistic sensitivities toward IMF prescriptions, while offering bankers some assurance that a reasonable stabilization program is in effect.

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If Brazil persuades the banks to cooperate, other Latin American debtors, particularly Mexico, may be encouraged to negotiate directly with bankers in seeking additional debt relief. Bankers accordingly might have to choose between continued financial assistance on the basis of each country's self-imposed stabilization program or cutting credit to the region. The latter would strain repayment capabilities and heighten prospects for a revolt by debtor nations.

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Plunging Commodity Prices Increasing LDC Financial Strains

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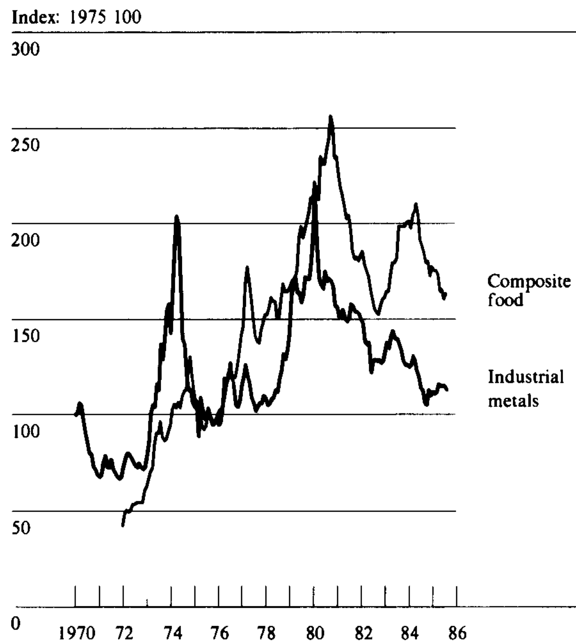
The dramatic five-year fall in prices of nonoil commodities and resulting export earnings losses have been particularly stressful for key LDC debtors.[1] Most of these countries are highly dependent on a few commodities to earn the bulk of foreign exchange needed to service their debts and import capital goods for development purposes. We estimate that this year's drop in commodity prices could cost the major LDC debtors $4.5 billion in export revenue this year. LDC oil exporters who also rely on nonoil commodity exports will be the hardest hit. For 1986 a modest recovery in nonoil prices will be more than offset by continued declines in oil prices, and the LDCs will suffer another, although less severe, drop in revenues.

Commodity Prices



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Sizing Up the Decline

Nonoil commodity prices, measured in US dollars, have fallen by 30 percent since their peak in 1980 while oil prices are down 19 percent from their 1981 high. An index of industrial materials prices shows a 33-percent drop since 1980, including a drop of 11 percent through the first eight months of 1985 alone. Food prices have fallen 27 percent since 1980 and 12 percent so far in 1985. In both cases, the recovery from the 1981-83 recession has been unusually weak and unsustained.

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Metals have been hardest hit. Although some prices currently show a slight improvement over 1984 levels, the potential for future gains appears modest. Inventory overhangs and the strong dollar are keeping the dollar prices of metals from rising significantly. Even though inventories are beginning to decline, production capacity still greatly exceeds demand—which has not exhibited the growth experienced in previous recoveries. Despite depressed markets, LDC producers have not reduced output because of the need to maintain revenue and employment. In fact, the strong dollar permits the LDCs to produce and sell at a profit even at current low prices, further increasing the incentive to maintain production. For example,

[1] Argentina, Bolivia, Brazil, Chile, Colombia, Indonesia, Malaysia, Mexico, Nigeria, Peru, Philippines, and Venezuela.

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Metal Market Trends

Copper. *Prices rose 9 percent from yearend 1984 levels, but remain well below peak 1980 levels. A recent buildup of stocks on the London Metals Exchange (LME) has kept prices relatively flat. A glut of producing capacity along with lower economic growth rates of major copper importers, especially the United States, will keep prices from rising significantly through 1986.* [redacted]

Aluminum. *Although cutbacks in production have continued and inventories have declined, prices have slid about 7 percent since the beginning of the year. Prices for the rest of this year will not rise above current levels, and a modest recovery is expected in 1986 assuming continued consumption increases and production cutbacks.* [redacted]

Tin. *Prices are currently roughly 8 percent above yearend 1984 levels, largely because of the decline of the dollar. Nonetheless, the market remains oversupplied due to overproduction, large world stocks, and declining usage, and average prices for the year will be below the 1984 level. Industry forecasters estimate decreases in world inventories of approximately 16 percent and 20 percent for 1985 and 1986, respectively, but global stocks would still amount to about 5 months of non-Communist annual consumption. This large overhang of inventories along with increased production by nonmembers of the International Tin Council (ITC) will put downward pressure on prices.* [redacted]

Silver. *Prices hit a three-year low in March and have since rebounded but remain 25 percent below the 1984 average price. A world surplus of 54 million ounces is expected in 1985 as industrial demand will not keep pace with the growth in supply. Nonetheless,* [redacted] *prices could rebound somewhat in 1986.* [redacted]

Chile produces copper at about 40 cents per pound, well below the current price of 65 cents per pound. [redacted] 25X1

Record harvests, huge stocks, and weak demand are currently putting downward pressure on LDC agricultural prices. Competition from developed countries, particularly the EC, has been strong, and, in the grain market, for example, some traditional importers, such as China and India, have begun to export grain. With Soviet and LDC demand at low ebb, prospects for a turnaround remain distant. [redacted] 25X1 25X1

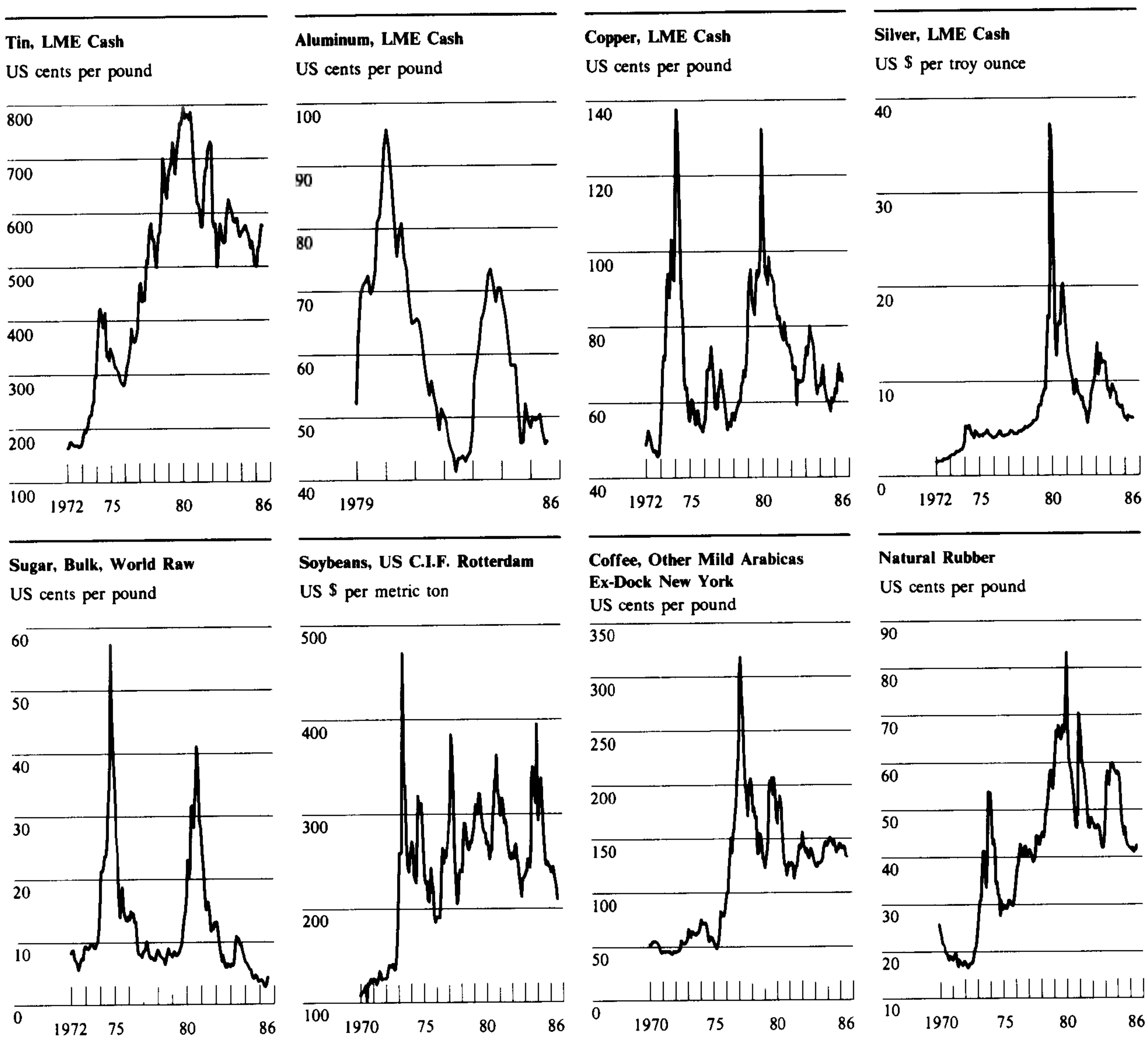
Implications for Key LDC Debtors

According to our analysis the drop in key commodity prices could cost the major LDC debtors $4.5 billion in export revenue this year—about 4 percent of overall export earnings—with several countries likely to record substantial declines. Oil exporters, especially those with significant nonoil commodity exports, probably will be hardest hit: 25X1

- Lower oil prices, as well as slumping prices for palm oil and rubber, are likely to cost Malaysia nearly $1 billion in export earnings this year, and Indonesia about $500 million in export revenue.
- Mexico could suffer a loss of over $1 billion, due to the drop in oil prices and weakness in the markets for its agricultural and seafood exports. [redacted] 25X1

Losses in 1985 will not be as large for the nonoil exporters, but several countries could experience a significant drop in export revenue. Lower corn, beef, and wheat prices will cost Argentina more than $300 million in export earnings. Brazil's export losses could reach $600 million, primarily due to a sharp drop in soybean prices. Plunging prices for coconut products likely will slash Philippine exports by $160 million. Only Chile and Colombia are likely to post export gains, and these will be modest at best. In the case of Chile, copper prices will rise only moderately for the year as a whole, 25X1 25X1 25X1 25X1

Selected Commodity Price Trends, 1970-86[a]



[a] Monthly averages.

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Agricultural Market Trends

Grain. *Wheat prices in nominal terms are at their lowest levels since 1978 and in real terms at their lowest since the early 1930s. Prices have fallen almost 20 percent in 1985 alone. The dropoff in corn, rice, and soybean prices has been similarly steep. While the strong dollar has accounted for some of this decline, overproduction, in the face of weak global demand is the dominant factor.* [redacted] 25X1

Sugar. *World sugar prices have been hovering near a 15-year low and until global stocks are reduced world prices should remain depressed. Latin American and Asian sugar exporters with access to the premium-priced US quota market will also experience earnings losses as US quota imports continue to contract.* [redacted] 25X1

Coffee. *A record global coffee harvest is currently forecast by USDA for 1985/86, contributing to this year's 8 percent price dip and adding to already burdensome stock levels. LDC exporters, short of domestic storage and critically in need of export earnings, have been unloading surplus coffee to nonmembers of the International Coffee Organization at one-half the price paid by members. Unless the growing two-tier price market for coffee is resolved, LDC coffee earnings could slip in 1986 on a further weakening of prices.* [redacted] 25X1

Cotton. *The global cotton market continues to slump, with trade volumes declining and a high stock overhang depressing prices to 10-year lows. Weakness in the cotton market signals slowing growth in export earnings for key debtors such as Brazil and Mexico as well as Pakistan and Sudan.* [redacted] 25X1

and prices for premium Colombian coffee should remain relatively stable despite large outstanding global stocks. In addition, prices for fruits and vegetables—major commodity exports for both countries—will, at best, rise slightly. [redacted] 25X1

Key Export Commodities: Importance to LDC Debtors

	LDC Debtors
Industrial materials	
Copper	Chile, Peru, Philippines
Aluminum	Venezuela, Brazil
Tin	Bolivia, Malaysia, Indonesia, Brazil
Silver	Mexico, Peru
Iron ore	Brazil, Peru, Chile
Lead	Peru, Mexico
Zinc	Peru, Mexico
Rubber, natural	Malaysia, Indonesia, Thailand
Petroleum	Nigeria, Mexico, Malaysia, Indonesia, Venezuela
Agricultural products	
Sugar	Brazil, Colombia, Philippines
Coffee	Colombia, Brazil, Indonesia, Mexico
Cocoa	Nigeria, Brazil
Cotton	Mexico, Pakistan, Brazil
Beef	Argentina
Coconut oil	Philippines
Fishmeal	Peru, Chile
Palm oil	Malaysia
Corn	Argentina
Wheat	Argentina
Rice	Thailand, Pakistan
Soybeans	Argentina, Brazil

[redacted] 25X1

Declining commodity prices and the resulting loss of export revenue are restraining potential import gains this year for oil-exporting key debtors. In turn, slower import growth will contribute to reduced real GNP gains in Indonesia and Malaysia, while in Mexico lower export revenue is aggravating debt-servicing problems. Nigeria remains mired in economic stagnation as falling oil revenues force further import cutbacks.[2] [redacted] 25X1

[2] Lower oil prices will, of course, benefit oil-importing countries, many of whom are also commodity-exporting LDCs. In most cases, however, the loss in export revenue due to lower nonoil commodity prices is not offset by the impact of lower oil prices. [redacted] 25X1

Major LDC Debtors: Impact on Export Earnings of Key Commodity Price Changes [a]

	1985		1986	
	Million US $	*Percent*	*Million US $*	*Percent*
Total	**−4,592**	**−4**	**−737**	**−1**
Argentina	−317	−4	18	NEGL
Bolivia	−24	−4	50	8
Brazil	−626	−2	129	NEGL
Chile	72	2	293	7
Colombia	51	2	128	4
Indonesia	−491	−3	−291	−1
Malaysia	−957	−6	−98	−1
Mexico	−1,099	−5	−308	−1
Nigeria	−422	−4	−408	−4
Peru	−35	−1	186	6
Philippines	−160	−3	−29	−1
Venezuela	−584	−4	−407	−3

[a] The impacts presented are calculated as the annual percent change in the price of each of the top commodity exports (including petroleum exports) for each country, multiplied by the country's annual exports of these commodities, and summed. Export volume is assumed to be unchanged.

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Outlook

The outlook for 1986 is more optimistic for the nonoil exporters—private forecasts indicate a modest recovery in the prices of most nonoil commodities. Oil prices, however, are forecast to decline further, adversely affecting oil-exporting key debtors. As a result, we believe that the group of key debtors as a whole will suffer an overall loss of export revenue due to changing commodity prices, although the magnitude of the drop will be much smaller than in 1985:

- Modest increases in tin, silver, and zinc prices should boost Bolivian export revenue.
- Chile will benefit from improved prices for copper, fruits, and vegetables.
- Stable coffee prices and higher fruit and vegetable prices are likely to boost Colombian exports.
- Prices for Peru's major commodity exports—silver, fishmeal, zinc, and lead—should rise.

On the other hand, continued weak prices for wheat and corn will limit export gains in Argentina, and a further decline in the price of coconut products will retard Philippine export growth.

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Among oil-exporting key debtors the outlook for 1986 is less optimistic, especially for those countries with few nonoil commodity exports. An additional $1 fall in oil prices could cost Nigeria and Venezuela over $400 million in export earnings next year. Mexican losses could total over $300 million. Indonesia and Malaysia, however, will benefit from a modest recovery in the prices for rubber and timber. As a result, their export losses will be sharply reduced compared to 1985, despite lower oil prices and continued weakness in the palm oil market. 25X1

Beyond 1986 the outlook is for continued weakness in commodity prices based on both secular and cyclical trends. According to Chase Econometrics, OECD GDP growth will average slightly below 3 percent through 1990—holding down demand growth for industrial metals and failing to alleviate the surplus capacity problem. Similarly, the demand for agricultural products—especially grain—will be throttled by slow economic growth in the LDCs and continued overplanting in the United States, Canada, Australia, the EC, and Argentina. While the dollar may continue to decline, it probably will remain strong relative to the early 1970s when commodity prices soared. These trends will cause continuation of earnings difficulties for LDCs who count on commodities for about 40 percent of their export revenues. 25X1

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Libya: Foreign Labor RIFs [redacted]

Libya's expulsion of thousands of foreign nationals since early August threatens to destabilize Tunisia and is causing less severe problems for Egypt and several other regional states. A primary reason for the deportations is the sharp falloff in Libya's oil revenues that has necessitated cuts in the use of costly foreign labor. Libyan leader Qadhafi, however, probably is taking advantage of the expulsions to cover the infiltration of Libyan-trained dissidents into neighboring states. We believe he will use the dissidents to try to undermine an orderly presidential succession in Tunisia and to exploit any domestic unrest generated by deteriorating economic conditions in Tunisia and Egypt. Qadhafi's actions, however, have heightened regional resolve to contain him and will exacerbate Libya's already serious economic problems. [redacted]

Qadhafi's Motives

Qadhafi's sudden expulsion of some 65,000 Tunisians, Egyptians, Syrians, Nigeriens, Malians, and other foreign nationals—about 13 percent of Libya's foreign population—since 5 August underscores his growing security concerns and Libya's mounting economic difficulties. The expulsions probably are, in part, intended to reduce the internal security threat in Libya by drawing down the number of foreign residents from countries Qadhafi distrusts [redacted] President Bourguiba's visit to the United States in June, US Bright Star excercises with Egypt, as well as Qadhafi's perception of growing US influence in regional and Arab affairs are the keys to the timing of the recent bout of deportations. [redacted]

A primary reason for the foreign personnel cuts, however, is to reduce the $2.4 billion Tripoli spends on foreign labor—almost 30 percent of the work force at the end of 1984. Tripoli will save as much as $550 million annually in worker remittances and support costs from the reductions so far. [redacted]

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Expatriates in Libya [a]

	1984	September 1985
Total	**499,500**	**375,000**
Egypt	170,000	130,000
Tunisia	70,000	39,500
USSR and Eastern Europe	70,000	65,000
Turkey	60,000	40,000
Syria	20,000	5,000
South Korea	18,000	18,500
Sudan	18,000	18,000
Italy	15,000	9,000
Morocco	10,000	14,000
United Kingdom	8,500	6,000
West Germany	4,000	4,000
France	3,000	2,000
Greece	2,000	2,000
United States	1,000	1,000
Other	30,000	21,000

[a] Estimated.

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[redacted]

The sharp slide in oil revenues—55 percent since 1980—and stiff austerity measures to cope with the loss have taken a heavy toll on the economy and living standards. Import reductions have forced sharp cuts in consumer goods and foreign exchange reserves have dipped to $4 billion forcing the cancellation or delay of many development projects. [redacted] the growing consensus among Libyans is that Qadhafi's social experiment has failed and that change is needed. [redacted]

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Foreign Nationals Expelled From Libya Since 5 August 1985 [a]

Total	**64,900**
Tunisia	30,500
Syria	15,000
Egypt	10,500
Niger	5,000
Mali	2,600
Algeria	800
Mauritania	500

[a] Estimated.

[redacted]

Who Goes?

Libya's dependence on foreign expertise to keep its small modern economy operating precludes the deportation of all foreign workers at this time, but the expulsion of select groups of expatriates probably will continue for several months. Qadhafi has maintained since 1982 that Libya cannot afford the luxury of foreigners performing menial jobs, which he claims should be done by Libyans. For the moment Tripoli is exempting highly skilled personnel, including doctors and technicians in petroleum and other key sectors, from deportation. The expulsion campaign has targeted unskilled workers, including large numbers of bakers, agricultural laborers, garbage collectors, and construction workers. The regime has confiscated the personal property and funds of those deported, which probably will be used to redress shortages of consumer goods and dwindling foreign exchange reserves. [redacted]

Libya has used the expulsion of workers as a diplomatic weapon since the early 1970s as well as a vehicle for positioning Libyan agents and sympathizers. Large numbers of Tunisians were expelled in 1976 after the Libyan-Tunisian union failed and again in 1979 following an offshore boundary dispute. Moreover, in a 1 September speech, Qadhafi reiterated his threat to punish any Arab ruler who officially visits the United States or has what Qadhafi views as an unacceptably close relationship with Washington. [redacted] 25X1

The Regional Impact

Tunisia has borne the brunt of the recent round of deportations and faces its most serious domestic crisis since the January 1984 bread riots. Over 30,000 workers have been returned so far. Tunis has retaliated by expelling 30 Libyan diplomats and 250 other Libyans, closing the Libyan cultural center, reinstating visa requirements, putting some military units in the south on alert, and ordering home all remaining Tunisians in Libya. Moreover, US Embassy sources claim that Algeria has pledged military support to President Bourguiba in the event of Libyan hostilities [redacted] 25X1

The expulsion of all Tunisian workers could cost Tunis as much as $140 million annually in worker remittances, lost trade, and added outlays for necessary social services. In addition, we estimate that unemployment would jump from August's 22 percent level to near 30 percent. [redacted] 25X1 25X1

The loss of income and increase in unemployment would almost certainly derail the regime's plans to reduce the trade deficit and burdensome consumer subsidies—critical items in government efforts to secure foreign financing and maintain the upper hand in labor negotiations. A large pool of unemployed workers would be available to support labor demonstrations against the government plans to hold the line on wages and raise staple food prices. Tunisia's powerful labor union has postponed promised strike activity so far, but has given notice that new agitation is likely this fall in response to continued government intransigence, according to the US Embassy in Tunis. [redacted] 25X1 25X1

The US Embassy in Cairo says the government is bracing for the return of as many as 50,000 ***Egyptian*** workers from Libya—mostly unskilled laborers—by the end of the year. More than 10,000

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Egyptians have been expelled since 5 August and another 30,000 workers had returned since the beginning of the year. The government has taken special precautions to prevent the infiltraton of Libyan subversives. Although doctors and other skilled professionals reportedly are exempt from Qadhafi's expulsion order, many are leaving of their own accord. [redacted]

Cairo's public welcome of returning Egyptian workers masks official concern that the shaky economy cannot accommodate such an influx. Real GDP growth of 5 percent barely covers the annual increase in the domestic labor force. Government bonus payments to workers and a massive subsidy program helps to cushion the effect of the economic malaise, but puts a heavy burden on national resources. With half the population under 25 years old and a recent history of labor unrest, the government is sensitive to labor problems and the threat posed by the possible return of a large number of expatriates over the next year from Libya and the Gulf. [redacted]

Qadhafi's Intentions . . .

[redacted]

Qadhafi almost certainly views Egypt and other states affected by the recent wave of expulsions as [redacted] While Tripoli probably will continue to return small numbers of Egyptian workers, the remaining 130,000 provide potential hostages in the event of direct Egyptian military action and a pressure point for use if deteriorating economic conditions in Egypt precipitate political unrest. While Qadhafi may try to infiltrate some Libyan-trained subversives into other states such a Niger or Mali, workers from these states are largely illegal aliens and are simply being returned. The small numbers in most cases will not affect their economies. [redacted] 25X1

. . . May Backfire 25X1

Libya's efforts to destabilize Tunisia have served to strengthen ties between Tunis and Algiers. The US Embassy in Algiers says that President Bendjedid and Bourguiba have agreed to coordinate military strategy toward Libya. While military cooperation between the two states probably has not gone much beyond contingency planning, Algeria does seem to have made a firm decision to buttress Tunisia with diplomatic, economic, and military assistance. 25X1
Moreover, Libya's actions have heightened Cairo's longstanding antipathy toward Qadhafi. [redacted]

Qadhafi's drawdown of foreign workers may also increase discontent among Libyans over deteriorating living standards. Many stores—especially bakeries—have been forced to close since the expulsions began, worsening food shortages in some areas of Tripoli. Moreover, previous attempts by the regime to force Libyans to perform menial work such as garbage collection have resulted in serious sanitation problems and the spread of disease because of popular disdain for such work. A dramatic and sudden deterioration in local lifestyles will accelerate the creation of a climate favorable to a move by Libyan exiles or domestic opponents. [redacted] 25X1

[redacted]

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Soviet Economic Assistance to the Communist LDCs [1]

Moscow continues to reap major political and strategic benefits in return for its hefty economic assistance to Communist LDCs (CLDCs). Although Soviet economic assistance has remained at roughly the same level over the past four years, Moscow is pressing the CLDCs to live up to commitments to provide the USSR with goods and raw materials. Cuba absorbs about two-thirds of the total while Vietnam and Mongolia account for the bulk of the rest. In return for Moscow's substantial economic help Cuba and Vietnam provide the Soviet military with much needed port and air facilities. Politically, the CLDCs continue to support Moscow in the UN and other international organizations.

Trade Subsidies

Roughly 50 percent of Soviet economic assistance to the CLDCs in recent years has been in the form of subsidized prices for both exports and imports. Cuba is the major recipient of the largess. Soviet oil sales are the principal source of trade subsidies, but the value of this subsidy varies because Moscow bases oil prices on the world average of the preceding five years. As a result of steeply rising world oil prices in 1979 and 1980, the value of the Cuban oil subsidy increased markedly, peaking at $1.7 billion in 1981. While world oil prices have fallen since 1982, however, the price charged by the Soviets has increased, and this subsidy nearly disappeared in 1984.

Prices for imports of Cuban sugar and nickel also are set annually, but are not tied to world prices. In recent years, Moscow has sharply increased the price it pays for Cuban sugar, apparently to compensate Cuba for rising oil prices. Thus, from 1981 to 1984, the subsidy on sugar increased from $1.4 billion to over $3.4 billion—more than offsetting the decline in the oil subsidy

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Direct Economic Aid

Direct economic aid, in the form of credits to either finance Soviet development projects or cover trade imbalances, comprises the rest of Soviet economic assistance.[2] Unlike trade subsidies, however—where Cuba received virtually the entire amount—Cuba, Vietnam, and Mongolia each received roughly equal amounts accounting for about 90 percent of the total:

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- ***Cuba:*** Of the $1 billion in Soviet direct economic aid to Cuba during 1984, roughly one-half went to finance major development projects, including the Punta Gorda and Cam I nickel plants, the Santiago textile factory, and the Havana thermal power station. The remainder went to finance the trade deficit. Despite increased Cuban oil production, Moscow provided Havana with 90 percent of its oil requirements in 1984.

- ***Vietnam:*** The troubled economy of Vietnam also relied heavily on direct Soviet economic aid during 1984—roughly two-thirds of which was trade credits for the purchase of raw materials, petroleum products, and essential industrial commodities. Vietnam's agricultural sector was especially dependent on Moscow for fertilizers, fuels and lubricants, and pesticides.

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[1] The Communist LDCs comprise Cuba, Vietnam, Mongolia, North Korea, Laos, and Cambodia.

[2] Grants and technical services are also included under this category. There is little direct information on the amount of this support, but, with the possible exception of Vietnam and Cuba, the amounts extended are probably small.

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USSR: Estimated Economic Assistance to Communist LDCs *Million US $*

	1980	1981	1982	1983	1984
Cuba	**3,463**	**4,558**	**4,666**	**4,260**	**4,620**
Economic aid	830	1,415	975	1,070	1,000
Trade [a]	245	912	481	500	460
Development aid [a]	540	453	444	520	490
Tecnical services	45	50	50	50	50
Trade subsidies	2,633	3,143	3,691	3,190	3,620
Sugar	1,165	1,366	2,580	2,740	3,420
Petroleum	1,480	1,657	1,006	345	100
Nickel	−12	120	105	105	100
Vietnam	**935**	**1,120**	**1,000**	**1,040**	**1,040**
Economic aid	580	900	950	1,025	1,040
Trade [b]	282	633	637	673	687
Development aid [b]	178	142	188	227	228
Grants [c]	50	50	50	50	50
Technical services [d]	70	75	75	75	75
Oil subsidies	355	220	50	15	NA
Mongolia	**835**	**830**	**885**	**885**	**785**
Economic aid	770	765	865	880	785
Trade [b]	218	247	188	240	202
Development aid [b]	552	503	662	625	568
Technical services		15	15	15	15
Oil subsidies	65	65	20	5	NA
North Korea	**260**	**145**	**130**	**40**	**55**
Trade and development aid [e]	75	65	70	25	45
Oil subsidies	185	80	60	15	10
Laos and Cambodia					
Development aid [b]	60	130	160	185	164

[a] Based on (a) estimated balance-of-payments aid necessary to cover Cuban soft currency trade deficits with the USSR; (b) Cuban purchases of capital goods from Moscow; and (c) public statements by Cuban and Soviet officials concerning the amount of development aid extended.
[b] Estimated from reported Soviet trade surpluses.
[c] Based on proportion of grants in reported commitments.
[d] Minimum estimated value of Soviet technicians in Vietnam and training of Vietnamese in the USSR.
[e] From reported Soviet deliveries of projected-related materials. Trends in Soviet trade surplus since the mid-1970s indicate that repayment on earlier credits are being made.

USSR: Summary of Economic Assistance to Communist LDCs *Billion US $*

	1980	1981	1982	1983	1984
Total	5.6	6.8	6.8	6.4	6.7
Trade subsidies	3.3	3.5	3.8	3.2	3.6
Economic aid	2.3	3.3	3.0	3.2	3.1

- ***Mongolia:*** Soviet economic aid to Mongolia in 1984 was just under $800 million. Under the terms of a five-year economic and technical cooperation agreement for 1981-85, the Soviets continued to supply aid for several major Mongolian development projects, including nonferrous metals extraction, agricultural development, and civil construction projects—primarily housing and buildings.

- ***North Korea:*** The Soviet Union's relationship with North Korea is more commercially oriented reflecting the more restrained political ties between Moscow and P'yongyang. Indeed, North Korea's merchandise exports to the USSR were $25 million more than imports in 1984. Even so, North Korea continued to benefit not only from subsidized oil prices but also from credits extended earlier to assist in the construction of industrial development projects.

Hard Currency Support

In addition to trade subsidies and direct economic aid, the Soviet Union has helped the CDLCs, primarily Cuba, cope with a severe shortage of hard currency. During 1984, Havana received almost $800 million in this type of aid. To this end, Moscow has:

- Purchased sugar and other commodities for hard currency outside the trade protocol.

- Allowed Cuba to reexport a portion of the 12 million tons of oil it provided.

Composition of Soviet Economic Aid to Communist LDCs, 1984

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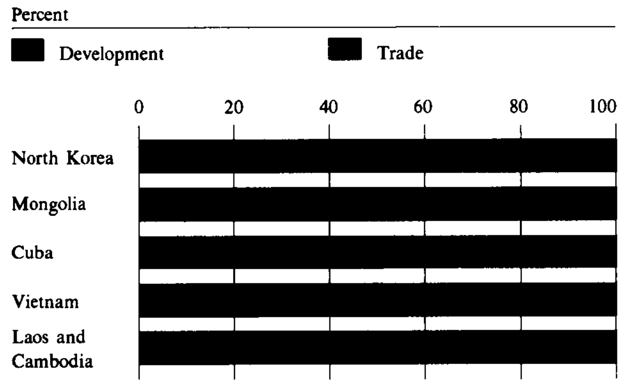

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- Paid Ottawa hard currency for the 1 million tons of grain Canada has shipped to Cuba annually since 1980 but has allowed Havana to repay in soft currency, saving it about $200 million in hard currency for 1984.

The USSR also provided Vietnam with hard currency support by acting as an intermediary for Hanoi's purchases of grain from Australia. Moscow pays Canberra hard currency for grain shipped to Vietnam, while charging the Vietnamese soft currency.

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The Soviet Side of the Ledger 25X1

The USSR receives substantial political, strategic, and economic benefits in return for its economic assistance. Cuba remains the USSR's most important asset in the Western Hemisphere, while both the Cubans and Vietnamese provide the Soviet military with much-needed port and air facilities. Politically, the CLDCs continue to support Moscow in the UN and other international organizations. Castro, in particular, has been aggressive in

promoting the Soviet Union's political position on various international issues and in defending Moscow in the Nonaligned Movement.

To a lesser extent, Soviet aid to these countries has benefitted Moscow economically. By gearing its assistance to those projects that will result in increased exports, Moscow obtains foodstuffs, raw materials, and other needed commodities. In addition, Moscow's assistance for energy-related projects in recent years should help reduce future oil exports to the CLDCs—presently about 6 percent of total Soviet oil exports—freeing up additional oil for consumption or hard currency sales. The USSR is helping to locate and extract coal, oil, and gas in a number of the CLDCs—notably Vietnam and Cuba. In addition, the Soviet Union began assisting Cuba in the construction of a nuclear power station that Havana claims will reduce oil costs $120 million annually per reactor.

Looking to the Future

Despite the benefits it receives, Moscow continues to press the CLDCs to give more in return for its economic aid. At the CEMA heads of government meeting last November, Moscow again insisted that Havana begin meeting targets for exports to CEMA countries on which it has fallen short in recent years. The Soviets also persisted in their calls for Hanoi to increase the production of export goods, taking into account the needs of the Soviet economy.

Officials in a number of the CLDCs, however—notably Cuba and Vietnam—have complained about Moscow's focus on those projects that will lead to increased exports of raw materials and agricultural goods to the USSR. The CLDCs have indicated a preference for Moscow to gear its project aid more toward industrial development—with its long-term benefits—rather than the extraction of limited natural resources.

Despite the complaints voiced by both sides, however, we look for no fundamental change in the pattern of Soviet economic aid. Given the substantial benefits it receives—and the poor state of the CLDCs economies—Moscow probably will be unwilling to trim its economic aid for fear of exacerbating economic problems in the CLDCs.

Indeed, in the case of Cuba and Vietnam, where Moscow receives its greatest political and strategic returns—some increase in economic aid seems likely. The recent signing of the 1986-90 trade and aid agreement with Vietnam, for example, reportedly calls for a doubling of aid during this period compared to 1981-85 and may reflect, at least partially, payment for the Soviet use of Cam Ranh Bay. Similarly, Soviet deliveries for a new nuclear power plant in Cuba could run into several hundred million dollars over the next few years, possibly resulting in some increase in total aid during this period. Finally, Soviet–North Korean political relations have improved over the past year or so, and it is possible that this warming trend will result in increased Soviet economic assistance as North Korea prepares to launch its new long-term economic plan next year.

From the CLDCs perspective, these countries have few alternatives but to seek as much Soviet assistance as possible. Substantial aid from Western sources is unlikely in the near term as is any appreciable amount of foreign investment because of the poor condition of their economies.

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Briefs

Energy

OPEC Production Declines

OPEC crude oil output in August averaged 14.7 million b/d, a small decrease from July levels. Weak oil demand and continued strong competition from non-OPEC producers kept production more than 1 million b/d below the organization's self-imposed ceiling. A coup in Lagos and a spate of Iraqi attacks on Khark Island did not prevent Nigeria and Iran from offsetting a 0.5 million b/d drop in Saudi output.

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OPEC: Crude Oil Production, 1985 *Million b/d*

	Quota	First Half	July	August
Total	**16.00**	**16.0**	**14.9**	**14.7**
Algeria	0.66	0.7	0.7	0.7
Ecuador	0.18	0.3	0.3	0.3
Gabon	0.14	0.2	0.2	0.2
Indonesia	1.19	1.2	1.3	1.2
Iran	2.30	2.4	2.2	2.4
Iraq	1.20	1.3	1.4	1.4
Kuwait[a]	0.90	1.1	0.9	1.0
Less share of Neutral Zone		0.9	0.8	0.8
Libya	0.99	1.1	1.1	1.1
Nigeria	1.30	1.5	1.0	1.3
Qatar	0.28	0.3	0.3	0.3
Saudi Arabia[a]	4.35	3.4	2.9	2.4
Less share of Neutral Zone		3.2	2.7	2.3
UAE	0.95	1.1	1.1	1.1
Venezuela	1.56	1.6	1.5	1.5

[a] Neutral Zone has no production quota; output is divided between Saudi Arabia and Kuwait and included in their country quotas.

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Venezuelan Oil Export Trends

[redacted]

Venezuela's decision in late July to cut the prices of its heavy grades of crude oil by about $2—to $21 to $24 per barrel—paid off last month in a sharp increase in exports to 1.6 million b/d, according to the Vice Minister of Energy. The price cut was prompted by similar moves by other producers—especially Mexico—which held Venezuelan exports to 978,000 b/d in June and 1.2 million b/d in July, far below the government's 1985 target of 1.4 million b/d. First half 1985 petroleum sales were $6.1 billion—almost $2 billion below the same period of 1984—raising questions about Venezuela's ability to finance economic recovery and meet $5-6 billion in annual debt service requirements. Although the new numbers may give the government hope, 1985 oil revenues will fall at least $1.5 billion below budgeted levels. This spells continuing austerity and depressed investor confidence, further delaying the hoped-for recovery. [redacted]

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Oil Exploration in Northern Mexico

[redacted]

Despite government austerity measures, PEMEX is continuing exploration in the Gulf of California to boost declining reserves and provide easier access to western US and Asian markets. [redacted] Last year Mexico announced a reduction in proved reserves, and a major oil find would provide a needed economic and psychological boost. [redacted]

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[redacted]

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Progress on New Qatari Gas Project

[redacted]

Development of Qatar's large North Dome field for the liquefied natural gas (LNG) export market took another step forward in early September when Japan's Marubeni trading company obtained an equity interest in the project. In exchange, the company made a commitment to market 2.8 billion cubic meters (bcm) annually—one-third of the planned output—after 1992. Other participants in the project are British Petroleum, Compagnie Francaise des Petroles, and the Qatari state petroleum company. The remaining 5.6 bcm has

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not yet been sold, and may face stiff competition from other LNG suppliers to Japanese and Asian markets. Tokyo already has sufficient supplies tentatively lined up to meet about three-fourths of its natural gas requirements through 2000. According to US Embassy reporting, Marubeni's signing makes it less likely that Doha will pursue the idea of building a gas pipeline through Turkey to serve Western Europe, thus removing one alternative to increased future Soviet gas sales to Western Europe. 25X1

Tokyo Prepares To Import Petroleum Products

To fulfill promises made at July's International Energy Agency meeting, MITI is quietly drawing up plans to open Japan's market for refined petroleum products. According to the US Embassy, MITI officials are considering a system requiring importers to be licensed to assure a secure supply of domestically refined and/or imported products, quality control, and sufficient stockpiles. The Ministry likely will license only current Japanese refiners to assuage fears that Japan's trading companies will encroach on a fully opened market. MITI will announce its new program later this fall, with imports expected to begin next April. The Ministry hopes to avoid public leaks of specific liberalization moves, however, fearing petroleum industry opposition. 25X1

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International Finance

Japanese Politicians Call For Currency Summit

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Senior officials of the ruling Liberal Democratic Party (LDP) and leading businessmen last week urged Tokyo to host a conference on international monetary reform. Details of the proposed currency summit are vague, and the Japanese Government has not yet officially reacted. We believe the suggestion is designed to show Japan's desire to ease trade frictions and to help ensure the success of the May 1986 economic summit, which Tokyo will host. Nonetheless, it is doubtful that a special meeting—if held—would yield any concrete scheme to remedy currency misalignments. Instead, as happened at the "Group of Ten" meeting of deputy finance ministers in spring 1983, the participants are likely to reject any proposals to set target zones for exchange rates.

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Italy Reschedules Iraqi Debts

Italy's agreement last week to reschedule nearly $500 million in Iraqi debt payments due in 1985 is another success in Baghdad's continuing efforts to delay foreign debt payments until oil earnings increase. Moreover, the US Embassy in Baghdad reports that three Italian companies agreed to accept repayment—about $100 million—in crude oil at official prices, apparently to protect Italian access to the Iraqi market. Baghdad previously had been unable to persuade Western creditors to accept oil for debt payments.

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IMF Delays Liberia Decision

[redacted]

The IMF's Executive Board has postponed until 25 November a decision to rule Liberia ineligible to use Fund resources. Monrovia made no firm commitments regarding payments to the Fund during a review in late August. A revised budget, which Liberian officials probably hope will buy them time until after the election scheduled for 15 October, does not provide adequate resources to meet the growing overdue obligations to the Fund. The Board is frustrated with Liberia's inaction on paying arrears and is likely to declare Liberia ineligible in November, blocking Liberia's access to IMF facilities until all outstanding debts to the Fund are repaid. [redacted]

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North Korea Searching for Funds

[redacted]

P'yongyang is continuing its efforts to obtain Western credits, probably to finance plant and equipment imports for the next seven-year economic plan (1986-92). Some of the money may be intended to meet payments on North Korea's roughly $1.3 billion hard currency debt. [redacted] P'yongyang's bad payments record may dissuade potential lenders, and Western government guarantees for these or any other credits are unlikely. Recent pledges to some Western countries to resume payments on arrears undoubtedly have the ring of P'yongyang's many failed promises of the past. [redacted]

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Global and Regional Developments

Pacific Regional Trade Meeting

[redacted]

Senior trade officials from Australia, Brunei, Indonesia, Japan, Malaysia, New Zealand, the Philippines, Singapore, South Korea, and Thailand strongly reaffirmed support for a new GATT trade round during a regional trade meeting last week. They expressed concern about growing protectionism, acknowledged the need for effective enforcement procedures in GATT, and cautiously supported including trade in services on the agenda. The 10 countries agreed on the need for a reduction in trade barriers for tropical products, textiles and clothing, and agricultural goods; they expressed particular concern about protectionist sentiment in the US Congress. This strong support for a new GATT round will help to offset opposition by Brazil and India. Indonesia, the principal opponent of US participation in the group, appeared to soften its stance, but future support for US participation is far from assured. [redacted]

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EC Likely To Resolve US Canned Fruit Dispute

The EC has reacted to the US imposed deadline for resolution of the canned fruit dispute with restraint, and may even accept a GATT panel recommendation to restore competition in the EC canned fruit market. The 1983 GATT report found that EC production aids to fruit canners had nullified tariff advantages granted US canned fruit exporters, but the EC has blocked adoption of the report, leading to the US deadline. The EC Commission considers this dispute relatively insignificant in view of the upcoming steel negotiations with the United States and the decrease in production aids to fruit canners over the past two years. EC acceptance of the GATT recommendation is likely because it would meet US demands while allowing the EC to continue decreasing production aids without completely eliminating them. The EC may, however, try to tie a resolution to other issues, such as the US complaint against EC preferences on Mediterranean citrus.

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Increased Cooperation Among Central American Core Four

Costa Rican president Luis Monge, according to US Embassy reporting, is calling for increased economic consultations and cooperation among the Central American Core Four—Costa Rica, El Salvador, Honduras, and Guatemala. Monge's plan focuses on reduced regional trade barriers, joint negotiations with the IMF and other multilateral organizations to increase international funding and modify stabilization conditions, and full implementation of the Jackson Plan for generous financial support to the area. According to Monge, his program would help revive sagging private sectors and also help isolate Nicaragua and focus attention on the Sandinistas' economic failures. Closer economic ties among the Core Four could help to boost regional trade and financial flows but not enough to boost significantly the area's sluggish economy.

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Growing Trade Squabbles in the Caribbean Community

Trinidad and Tobago's failure to implement the 14-month-old Caribbean Community (CARICOM) trade accord is prompting sharp criticism from neighboring countries and threatens the organization's viability. The accord would lower trade barriers among members and raise tariffs on imports from non-CARICOM countries. Four of CARICOM's 13 members have yet to implement the agreement—despite three deadline postponements—but Trinidad has drawn the most criticism because it is the largest market. To conserve its declining foreign reserves, Trinidad has slashed imports from CARICOM countries about 30 percent this year, after a decline of 18 percent in 1984. Grenada and Barbados have expressed the sharpest disapproval of Trinidad's trade policies. Barbadian Prime Minister St. John recently even suggested that Caribbean governments restrict purchases of Trinidadian products until Port-of-Spain relaxes its import restraints. Given its worsening economic problems, however, Trinidad is likely to make only token efforts to soften its import policies.

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National Developments

Developed Countries

[redacted]

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Canadian Commission Supports Free Trade With the United States

[redacted]

The recent report of the Macdonald Royal Commission on the Canadian Economic Union supports a free trade agreement with the United States, but only if Canadian industry and sovereignty can be protected. Proposed safeguards include a 10-year phasein to help Canadian firms adjust to increased competition; funds to retrain workers who lose their jobs because of free trade; and the exemption of certain industries, such as automobiles. Proposed measures to reduce the unemployment rate—essentially by a devaluation of the Canadian dollar—would complicate any free trade agreement. The report emphasizes that an accord with safeguards would substantially boost Canadian industrial production, and that all provinces would benefit. Prime Minister Mulroney probably regards the study as a vindication of his attempts to promote freer trade with the United States, and may attempt to incorporate some of its recommendations into a proposal Ottawa will present to Washington this fall. [redacted]

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West German Reflation Even Less Likely

A surge in new domestic orders in July, coupled with the continued strength of the export sector, probably will strengthen Bonn's resolve not to reflate the economy. The 5-percent jump in the volume of new domestic manufacturing orders followed a solid 2-percent gain in the second quarter. Other indicators, such as retail sales and business surveys, also point to a pickup in the domestic economy. While the government will hold firm to its budget consolidation course, some easing of monetary policy is possible. Earlier this month, Finance Minister Stoltenberg and Bundesbank President Poehl said that they see scope for a further drop in interest rates, following the August reduction in the discount rate from 4.5 to 4.0 percent. 25X1 25X1

Italian Budget Deficit To Continue

Disagreement within the Cabinet on the 1986 budget will probably stall efforts to reduce the public-sector deficit, which is now over 15 percent of GDP. Treasury Minister Goria's latest proposals—increasing indirect taxes, capping public-sector wage increases at 6 percent, and cutting welfare spending by transferring some government services to the private sector—have met with strong opposition from ministers who want neither higher taxes nor cuts in their departments. Infighting over the budget and other contentious issues implies that the five-party coalition lacks the political will and cohesiveness to push through unpopular austerity measures. In order to reach agreement among coalition members, the Cabinet will almost certainly water down Goria's proposals, and the logrolling necessary to get the bill through parliament by the end of the year will probably weaken the measures to the point where they will have little impact on the deficit. 25X1 25X1

Italian Trade Deficit Worsens

Relatively strong domestic demand and declining export competitiveness pushed Italy's trade deficit to $8.5 billion for the first six months of 1985—a 68-percent increase over the same period last year. Although July's 7.8-percent devaluation of the lira is likely to help the trade balance toward the end of the year, the sharp increase in the deficit has stepped up industry demands for measures to improve Italy's competitiveness. In particular, business leaders are pressuring the government to slow inflation by limiting wage gains and controlling public spending. Rome's efforts probably will be ineffective, however. Moreover, the increasing capital intensity of Italian industry is boosting imports of intermediate and investment goods, and offsetting gains on the export side. 25X1 25X1

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Spanish Unemployment Declines

Registered unemployment in Spain fell in July for the fourth straight month, lowering the unemployment rate to 19.3 percent—down from a peak of 20.2 percent in March and the lowest rate in 10 months. The Ministry of Labor views this as proof of the success of government employment programs, but we are more wary. Part of the recent decline is seasonal—activity in the services and agricultural sectors usually picks up during the summer months. Nevertheless, the labor market is much stronger than it was last year. The number of unemployed has declined by 27,000 for the first seven months of the year, in contrast to an increase of 62,000 during January-July 1984. Additionally, the pickup in investment activity in the second quarter was largely responsible for an increase of 10,000 workers in the construction industry during July. With the seasonal gains in employment now largely past, however, we do not expect a further decline in the unemployment rate during 1985.

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Less Developed Countries

Pakistan Moves To Rebuild Trade With Iran

Pakistan recently signed a trade agreement with Iran that would restore bilateral trade which fell to less than $100 million last year to roughly $400 million annually. The agreement, to take effect 1 October, provides for a doubling of Pakistani imports of Iranian crude oil—to 20,000 b/d—in exchange for increased Iranian purchases of Pakistani textiles. The US Embassy in Islamabad says that Tehran had threatened to stop purchasing Pakistani goods unless Pakistan reduced its trade surplus with Iran. The surplus, combined with Iranian displeasure over poor quality Pakistani textiles and past violations of trade contracts, were the likely causes of the sharp drop in trade last year, from the previous year's $442 million level. The two countries probably hope to ease political tensions by improving trade relations.

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Foreign Investment in South Korea Falling Short of Goal

South Korea approved $207 million in direct foreign investment through mid-September—half the total for the same period last year and far off the pace needed to hit the overly ambitious $450 million target for 1985. Foreign investment last year was a record $419 million but was dominated by two projects—a $100 million investment by a US auto manufacturer and a $93 million addition to a Seoul hotel. Even so, yearend results should compare favorably to 1983 approvals of $268 million. Spurred by continued foreign investment liberalization, the 1988 Seoul Olympics, and burgeoning high technology and automobile industries, direct foreign investment should be robust over the next three years, with several projects in the $50-100 million range possible. If, however, businessmen perceive that Seoul is mismanaging the economy, President Chun is losing his grip on power, or a succession crisis is developing, they may balk at additional capital commitments.

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Burma's Export Prospects Worsen

Burma's exports for the fiscal year which began 1 April are likely to decline sharply from last year's level of $375 million, according to the US Embassy. Earnings from rice exports—which traditionally account for 40 percent of the country's foreign exchange revenues—plummeted 68 percent in the first five months of the fiscal year compared with the same period last year. Depressed commodity markets—along with Rangoon's poor pricing and marketing policies—will put a damper on most of Burma's other exports, as well. As a result, Rangoon probably will further curtail imports despite the impact on the country's long-term development prospects.

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Less Czechoslovak Trade With Nonsocialist Countries

Czechoslovakia's trade with nonsocialist countries—primarily the developed West—continued its steep slide during the first six months of 1985, down 12 percent from the same period a year ago. Its share of total Czechoslovak trade is now below 20 percent compared with 30 percent in 1980. First-half exports were down 12.4 percent from a year earlier. Because of the downturn in exports and continued priority on debt reduction, Prague cut imports by more than 11 percent despite plans for a 14-percent increase. This generated a robust trade surplus of $427 million, but deprived Czechoslovakia's aging industry of badly needed modern plant and equipment. Prague could ease up a bit; Czechoslovakia's debt is low, and it has considerable untapped borrowing capacity. Nonetheless, the regime apparently feels it must reduce hard currency debt to limit its vulnerability to Western political leverage.

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Weather Clouds Grain Export Prospects

Recent heavy rains and flooding are causing serious damage to an estimated 20 percent of the cropland in China's northeastern provinces, where much of the nation's corn—China's major export grain—is grown. A much larger area is threatened with less severe damage. Wet weather has also reportedly caused moisture and pest damage to stockpiles from last year's bumper crop. A weather-induced decline in the quantity of marketable corn could mean China will have trouble fully implementing its ambitious plans for expanding grain exports to earn foreign currency. Importers of Chinese grain are already complaining of delayed deliveries and defaults on contracts. The higher prices and lower quality likely to result from China's weather problems could cause buyers to seek other sources for corn.

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Beijing Appoints New Ministers

Beijing has appointed new heads of the ministries of Labor and Personnel, Metallurgical Industry, Geology and Mineral Resources, Public Security, and State Security in the second round of high-level changes this year. The changes are another step by Deng Xiaoping toward institutionalizing current economic reform policies by appointing younger—their average age is 15 years less than their predecessors—better-educated officials. All the new appointees have college-level educations and most appear to have solid connections to prominent reformers in the party. The replacement of reform economist, Ma Hong, with a 67-year-old historian, Hu Sheng, however, suggests that a more orthodox tone will prevail at the Academy of Social Sciences, which has taken a leading role in promoting economic liberalization.

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Vietnamese Currency Reform

Vietnam announced severe currency measures on Saturday and canceled all international flights to prevent an exodus of unofficial gold holdings or other forms of wealth. Hanoi allowed individuals five days to register currency holdings and set stringent limits on the amount that could be converted into new bank notes at a rate of one new note for 10 old ones. The announcement did not say how official market prices would be affected or what the new rate of exchange with the dollar would be. Hanoi had devalued last April from 10 dong to 100 dong per dollar to fight inflation and to curb black-market currency speculation. Even with strong followup measures, this latest move to shore up the sagging economy will have only a limited impact because of fundamental shortcomings in industrial and agricultural production and the drain of military operations in Cambodia. The move will disrupt foreign exchange transactions, including overseas remittances—the country's largest source of foreign exchange earnings. The measures also will disrupt some black-market activity and deprive unofficial currency holders of some financial gains.

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